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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

B-284498

February 1, 2000

Congressional Requesters

Subject: Social Security Reform: Evaluation of the Gramm Proposal

This letter responds to your request that we extend our previous analysis of the potential budgetary and economic effects of various Social Security reform proposals¹ to include the proposal put forth by Senator Phil Gramm. This letter follows the methodology and format of that report. Although Senator Gramm has advised us that he is in the process of revising his proposal, the specifics of his new proposal are not yet available. Thus, our analysis is based on the Senator's most recently available proposal. In summary, as agreed with your offices, our assessment of the Gramm proposal is based on the analytic framework we provided to the Congress last March, which consists of three basic criteria:²

- the extent to which the proposal achieves sustainable solvency and how it would affect the economy and the federal budget (see pages 13-18),
- the balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions) (see page 19), and
- how readily such changes could be implemented, administered, and explained to the public (see page 20).³

In evaluating the Gramm proposal against the three basic criteria, we used a set of detailed questions, included on pages 7-9, to determine potential effects of reform proposals on important policy and operational aspects of public concern.

¹ *Social Security: Evaluating Reform Proposals* (GAO/AIMD/HEHS-00-29, Nov. 4, 1999).

² *Social Security: Criteria for Evaluating Social Security Reform Proposals* (GAO/T-HEHS-99-94, Mar. 25, 1999).

³ *Social Security Reform: Implementation Issues for Individual Accounts* (GAO/HEHS-99-122, June 18, 1999) and *Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design* (GAO/HEHS-99-131, June 18, 1999).

As you requested, we used our long-term economic model in evaluating the proposal against the first criterion, that of financing sustainable solvency.⁴ Specifically, we used this model to simulate the potential fiscal and economic impacts of the Gramm proposal over a 75-year projection period. In simulating the reform proposal, we relied on income and cost estimates prepared by the Office of the Actuary at the Social Security Administration (SSA), and we adapted the model as appropriate to reflect specific reform proposal provisions. As you requested, our simulation results also compare the proposal with alternative fiscal policy paths developed in our prior model work.

We used qualitative research to examine how well the Gramm proposal balances adequacy and equity concerns and provides for reasonable implementation and communication of any changes. In so doing, we relied on our issued and ongoing body of work on Social Security reform. This work addresses various issues raised by reform approaches, including establishing individual accounts, raising the retirement age, and determining the impact of reforms on minorities and women.⁵

We provided a draft of this letter and the enclosure to SSA, and have incorporated its technical comments where appropriate. We conducted our work from October 1999 through January 2000 in accordance with generally accepted government auditing standards.

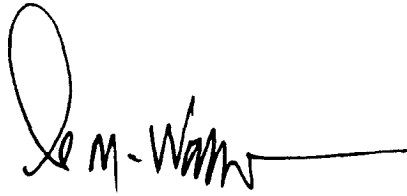
We are sending copies of this report to Senator Phil Gramm; the Honorable Kenneth S. Apfel, Commissioner of the Social Security Administration; and the Honorable Lawrence Summers, Secretary of the Treasury. Copies will be made available to others upon request.

⁴For our analysis of the Gramm proposal, we relied upon the economic and budget assumptions contained in the Congressional Budget Office's July 1999 baseline. These are the same assumptions we used in our earlier analysis of other Social Security reform proposals.

⁵See *Social Security: Individual Accounts as an Element of Long-Term Financing Reform* (GAO/T-HEHS-99-86, Mar. 16, 1999); *Social Security Reform: Implications of Private Annuities for Individual Accounts* (GAO/HEHS-99-160, July 30, 1999); *Social Security: Issues in Comparing Rates of Return With Market Investments* (GAO/HEHS-99-110, Aug. 5, 1999); *Social Security Reform: Implications of Raising the Retirement Age* (GAO/HEHS-99-112, Aug. 27, 1999); *Social Security Reform: Implications for Women* (GAO/T-HEHS-99-52, Feb. 3, 1999); and *Social Security and Minorities: Current Benefits and Implications of Reform* (GAO/T-HEHS-99-60, Feb. 10, 1999).

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If you or your staffs have any questions about this report, please contact Paul L. Posner, Director, Budget Issues, on (202) 512-9573, or Cynthia M. Fagnoni, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215.

A handwritten signature in black ink, appearing to read "D M Walker", followed by a horizontal line.

David M. Walker
Comptroller General
of the United States

Enclosure

List of Requesters

The Honorable John B. Breaux
The Honorable Charles E. Grassley
The Honorable Judd Gregg
The Honorable Robert Kerrey
United States Senate

The Honorable John R. Kasich
The Honorable Jim Kolbe
The Honorable Charles W. Stenholm
House of Representatives

Criteria for Evaluating Social Security Reform Proposals

The three basic criteria that provide policymakers with a framework for assessing reform plans:

- Financing Sustainable Solvency
- Balancing Adequacy and Equity in the Benefits Structure
- Implementing and Administering Reforms

Evaluating Social Security Reform Proposals

- Comprehensive proposals can be evaluated against three basic criteria.
- Reform proposals should be evaluated as packages that strike a balance among individual reform elements and important interactive effects.
- Some proposals will fare better or worse than other proposals under each criterion.
- Overall evaluation of each proposal depends on the weight individual policymakers place on each criterion.

Financing Sustainable Solvency

This criterion evaluates the extent to which the proposal achieves sustainable solvency, including how the proposal would affect the economy and the federal budget.

To what extent does the proposal:

- Reduce future budgetary pressures?
- Reduce debt held by the public?
- Reduce the cost of the Social Security system as a percentage of GDP?
- Reduce the percentage of federal revenues consumed by the Social Security system?
- Increase national saving?
- Restore 75-year actuarial balance and create a stable system?
- Raise payroll taxes, draw on general revenues, and/or use Social Security trust fund surpluses to finance changes?
- Create contingent liabilities?
- Include "safety valves" to control future program growth?

Balancing Adequacy and Equity

This criterion evaluates the balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions).

To what extent does the proposal:

- Change current-law benefits for current and future retirees?
- Maintain benefits for low-income workers who are most reliant on Social Security?
- Maintain benefits for the disabled, dependents, and survivors?
- Ensure that those who contribute receive benefits?
- Provide higher replacement rates for lower income earners?
- Expand individual choice and control over program contributions?
- Increase returns on investment?
- Improve intergenerational equity?

Implementing and Administering Reforms

This criterion evaluates how readily such changes could be implemented, administered, and explained to the public.

To what extent does the proposal:

- Provide reasonable timing and funds for implementation and result in reasonable administrative costs?
- Allow the general public to readily understand its financing structure and increase public confidence?
- Allow the general public to readily understand the benefit structure and avoid expectation gaps?
- Limit the potential for politically motivated investing?

Financing Sustainable Solvency: GAO's Long-term Economic Model

- GAO's long-term economic model is used to help assess the potential fiscal and economic impacts of Social Security reform proposals.
- The economic model was originally developed by economists at the Federal Reserve Bank of New York.
- The key interaction between the budget and the economy in the model is the effect of the unified federal deficit/surplus on the amount of national saving available for investment, which influences long-term economic growth.
- Long-term simulations provide illustrations--not precise forecasts--of the relative fiscal and economic outcomes associated with alternative policy paths.

Financing Sustainable Solvency: Alternative Fiscal Policy Simulations

Reform simulations are compared to several long-term simulations developed as part of GAO's ongoing model work. These simulations all assume payment of current-law Social Security benefits using general revenues to supplement payroll tax financing.

- **No action** assumes no changes in current policies and thus results in saving the unified surpluses. This assumption implies no emergency spending and that actual spending falls within the existing discretionary caps. Thus unified budget surpluses through 2029 are used to reduce debt held by the public. Thereafter, deficits are permitted to emerge. Discretionary spending follows CBO's 10-year projections which assume compliance with the spending caps through 2002 and growth with inflation through 2008. Thereafter we assume discretionary spending grows with the economy.
- **Eliminate non-Social Security surpluses** assumes that permanent unspecified policy actions (i.e., spending increases and/or tax cuts) are taken through 2009 that eliminate the on-budget surpluses. Thereafter, these unspecified actions are projected through the end of the simulation period. On-budget deficits emerge in 2010, followed by unified deficits in 2019.
- **Long-term on-budget balance** assumes that the on-budget surplus is eliminated through 2009, as in the previous path. Thereafter, the on-budget portion is kept in balance by actions that cut spending and/or raise revenue to prevent on-budget deficits from emerging. This results in a unified surplus/deficit equal to the OASDI trust funds' annual surplus/deficit through 2034 and equal to the Social Security annual cash deficit thereafter.

The Gramm Proposal¹

- Guarantees retirement income equal to at least current-law benefits plus 20 percent of the calculated annuity payment from the individual account investments.
- Mandatory individual “carve-out” accounts equal to 3 percent of taxable payroll plus an additional 2 percent carve-out for workers who are age 35 through 55 in 2000.
- Individual accounts structured as a carve-out of the current 12.4 percent payroll tax with the OASDI trust funds reimbursed from the general fund. This reimbursement is gradually reduced assuming OASDI tax income--including the recapture of corporate taxes resulting from individual account investments²--grows and the benefits financed directly from the trust funds decline. Under an assumed real return of 5.5 percent on account balances, the payroll tax necessary to finance OASDI benefits would fall to 5.8 percent.
- Benefit amount: current-law plus 20 percent of calculated annuity amount based on investment of 3 percent of taxable payroll. Social Security system would supplement annuity payment if less than the guaranteed benefit amount. Account balance is left to estate if worker dies before benefit receipt and has no potentially OASDI-eligible survivors.

¹Proposal as estimated by the Office of the Chief Actuary, Social Security Administration, April 16, 1999.

²The proposal assumes that 80 percent of the funds in the new individual investment accounts would be net additions to national saving, leading to additional investment and economic growth. The recapture reflects the resulting assumed increase in corporate tax revenues from this additional investment. In contrast to current law, as assumed in our model, the proposal is based on the assumption that projected budget surpluses would otherwise be spent and/or used for tax reductions. Under current-law assumptions, all projected budget surpluses are used to reduce debt held by the public.

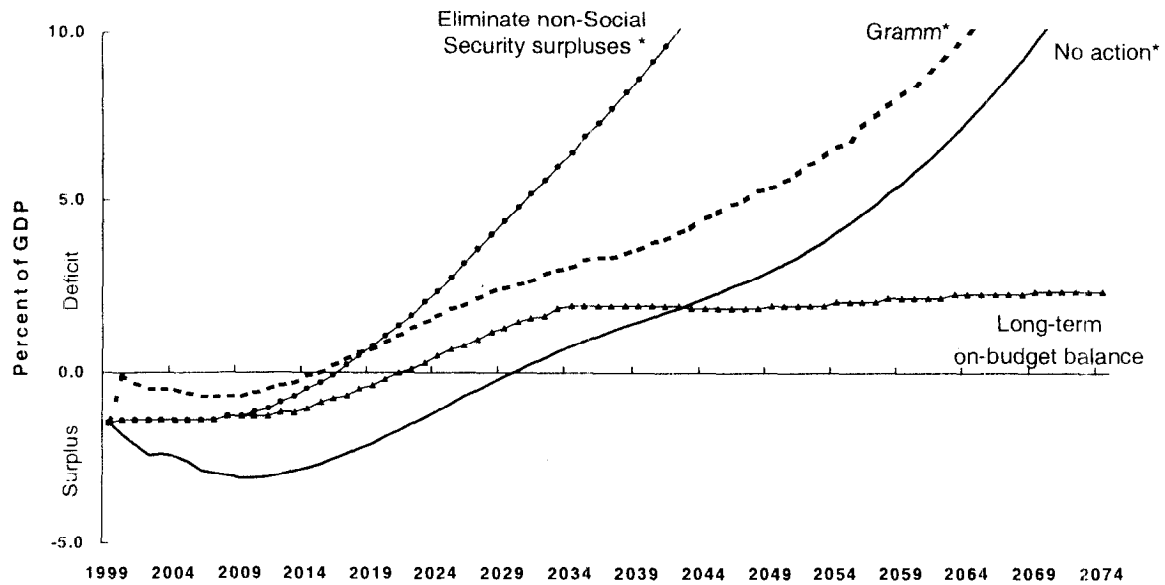
The Gramm Proposal Financing Sustainable Solvency

As illustrated in the following graphs, compared to No Action,¹ the Gramm proposal:

- Reduces projected unified surpluses and increases projected unified deficits as a share of GDP through the end of the simulation period. (Figure 1)
- Results in higher levels of debt held by the public through the end of the simulation period. (Figure 2)
- Lowers the cost of Social Security as a share of GDP in 2030 by 1.2 percentage points--about one-fifth. Compared to No Action, the proposal cuts the net government cost of the program as a share of GDP roughly in half by 2074. (Figure 3)
- Lowers Social Security spending as a share of federal revenues in 2030 by 4.6 percentage points--about one-seventh. In 2074, program spending would consume about half as much of federal revenues as in No Action--or about the same share of revenues as today. (Figure 4)

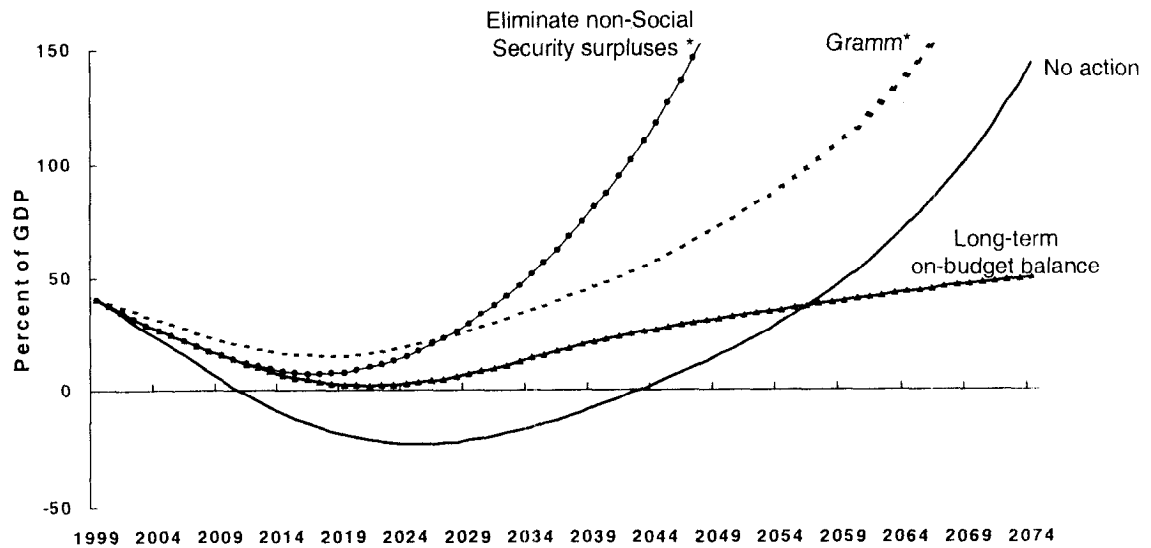
¹Our analysis of this and other reform proposals using our long-term economic model assumes continuation of current law (No action) in which all surpluses would be used to reduce debt. Since the individual accounts under the Gramm proposal are funded from payroll taxes and general revenues, they constitute a transfer of saving from the government to the private sector. Therefore, we assume that there is no additional investment or corporate tax revenue.

**Figure 1: The Gramm Proposal
Unified Deficits/Surpluses as a Share of GDP**



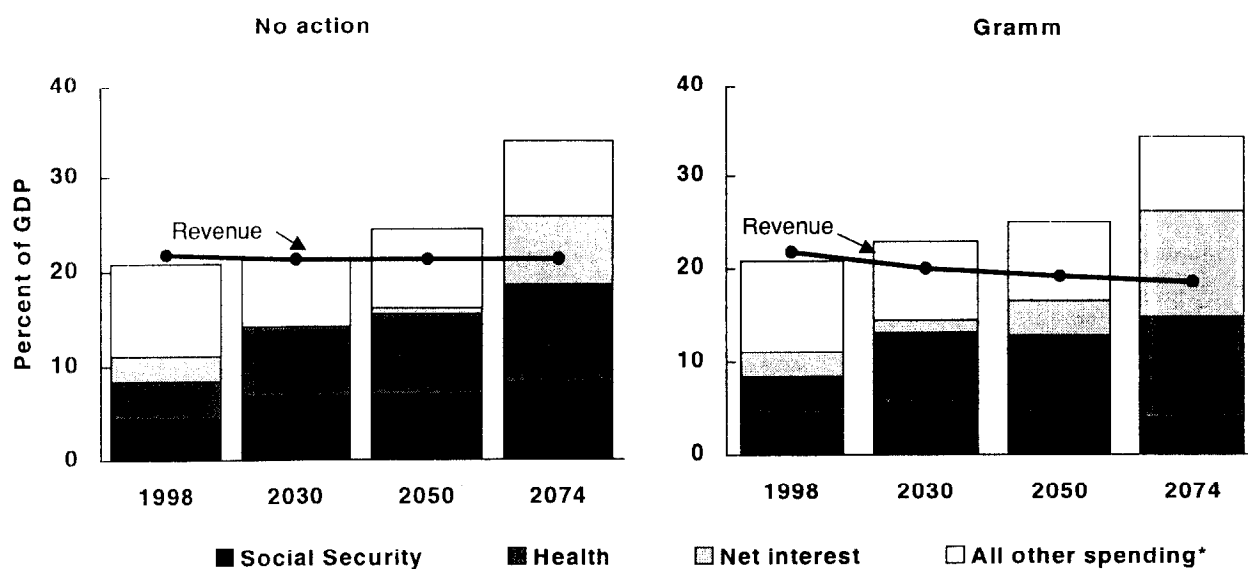
*Data end when deficits reach 10 percent of GDP.

**Figure 2: The Gramm Proposal
Debt Held by the Public as a Share of GDP**



*Data end when debt reaches 150 percent of GDP.

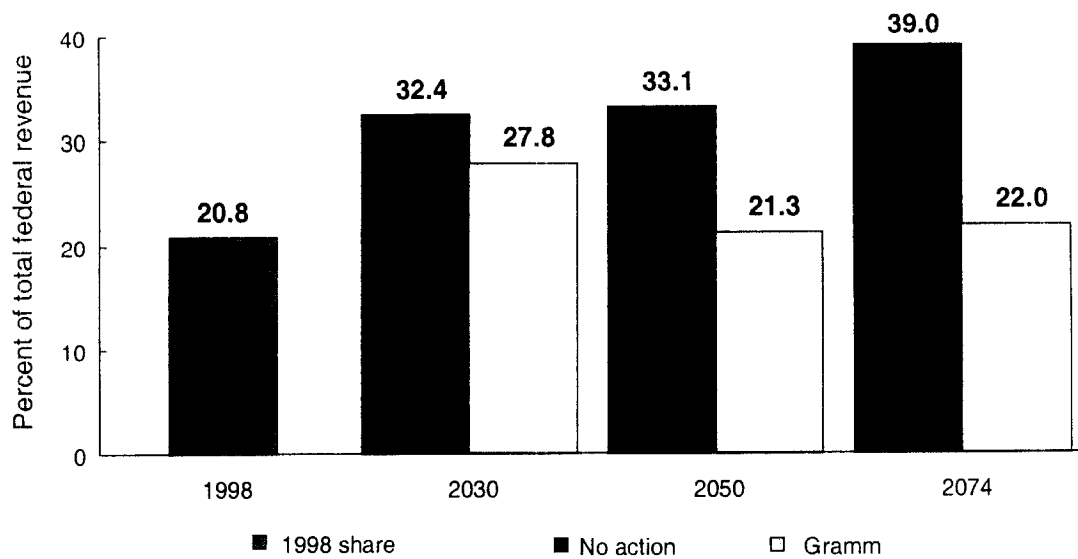
Figure 3: Composition of Spending as a Share of GDP in 1998 and Under No Action and Gramm



*All other spending includes offsetting interest receipts in 2030 under no action.

Note: Since a payroll tax carve-out reduces revenue, revenue under Gramm is net of the carve-out amount.

Figure 4: Social Security Spending as a Share of Total Federal Revenue in 1998 and Under No Action and Gramm



Note: Since a payroll tax carve-out reduces revenue, revenue under Gramm is net of the carve-out amount.

The Gramm Proposal Financing Sustainable Solvency

- National saving would be unchanged compared to current law. Government saving is reallocated to private saving through the creation of individual accounts funded by payroll taxes and general revenues.¹ SSA's actuaries estimate that after 2040, income to the trust funds would be more than sufficient to fund both Social Security benefits and individual accounts. At that time, "excess" payroll taxes could be used to increase the size of the individual account contribution which would leave national saving unchanged compared to current law, or payroll taxes could be reduced which would lower national saving.
- Restores 75-year actuarial balance and produces trust fund ratio that at the end of the 75-year projection period is rising by about 40 percentage points per year.
- Finances individual accounts from general revenues by means of (1) a declining reimbursement of the OASDI trust funds for the cost of the carve-out and (2) a growing transfer of corporate income tax revenue.² The reimbursement for the carve-out would be gradually reduced as the size of the corporate tax transfer increases and the benefits financed directly from the trust funds (net of the individual account offset) decline. Returns to the individual accounts determine the magnitude of the benefit offset and corporate income tax transfer.
- Creates a contingent liability through guarantee of at least present-law benefits plus 20 percent of the calculated annuity payment from the individual account investments.
- Contains no new "safety valves" to control future program growth.

¹Analysis limited to first order effects on saving. Effects on saving behavior in response to specific reform provisions are not considered given the lack of expert consensus.

²The proposed corporate tax transfer is based on the assumption that the individual account investments are net additions to national saving and would result in new corporate income tax revenues. Under our analysis of the proposal, national saving (and hence corporate income tax revenue) is unchanged.

The Gramm Proposal Balancing Adequacy and Equity

- The proposal guarantees current-law benefits, as well as 20 percent of the annuity from the amount based on the 3 percent contribution in the individual account. This could potentially improve benefits for current and future retirees, including low-income workers and others most reliant on Social Security.
- The proposal guarantees at least current-law benefits to disabled, dependents, or survivors.
- All workers who are in the workforce in 2000 or later are covered by the proposal. Workers who are age 35-55 in 2000 would have an additional 2 percent of their current payroll tax diverted to their individual accounts.
- The progressivity of the OASDI benefit structure remains unchanged. The account's initial 3 percent investment contribution could be increased in the future.
- There is potential for higher returns on investment, but 80 percent of the 3 percent investment will be recaptured by the government.¹
- The proposal does not specify what degree of choice and control workers would have over their contributions.
- The move to advance funding of Social Security may improve intergenerational equity.

¹The Social Security program would offset benefits by 80 percent of the amount accumulated with the 3 percent investment, and by 100 percent of the 2 percent investment.

The Gramm Proposal Implementing and Administering Reforms

- Funding for implementation is not explicitly discussed. The proposal provides no time frames for implementation.
- The proposal's maximum administrative cost estimate of 0.3 percent of assets each year may not be realistic, especially in the long term.
- The financing structure of the system may be difficult to explain.
- The "offset" feature of the benefits structure must be clearly explained; otherwise, retirees might expect a larger return than the proposal actually provides, potentially creating an "expectations gap."¹ An education program will be necessary.
- The proposal establishes a Social Security Investment Board to oversee fund management.

¹ The Social Security program would offset benefits by 80 percent of the amount accumulated with the 3 percent investment, and by 100 percent of the 2 percent investment.

Appendix I: Interpreting Long-term Simulations

- Long-term simulations provide illustrations--not precise forecasts--of the relative fiscal and economic outcomes associated with alternative policy paths.
- Long-term simulations are useful for comparing the potential outcomes of alternative policies within a common economic framework over the long term.
 - Recognizing the inherent uncertainties of long-term simulations, we have generally chosen conservative assumptions such as holding interest rates and total factor productivity growth constant. Variations in these assumptions generally would not affect the relative outcomes of alternative policies.
 - The model simulates the interrelationships between the budget and the economy over the long term and does not reflect their interaction during short-term business cycles.
- Long-term simulations are not predictions of what will happen in the future. In reality, policymakers likely would take action before the occurrence of the negative out-year fiscal and economic consequences reflected in some simulated fiscal policy paths.

Appendix I: Social Security Reform Proposals in the Model

- Reform proposal cost and income estimates are from SSA's Office of the Actuary.
 - For each proposal, the OASDI cost estimate reflects all proposed reforms affecting benefits. These include increases in the retirement age, reduced COLAs, changes in the index used to adjust initial benefit levels, benefit reductions meant to offset individual accounts, and other proposed changes.
 - For each proposal, the OASDI income estimate reflects such elements as transfers from the general fund to the trust funds, the redirection of revenue from the taxation of benefits from the HI trust fund to the OASDI trust funds, and carve-outs from the payroll tax used to establish individual accounts.
- For all reform proposals, on-budget revenue and spending reflect the assumptions included in GAO's no action path,¹ adjusted for proposed reform proposal changes affecting on-budget totals.
 - Changes include transfers from the general fund to the OASDI trust funds, tax credits used to fund individual accounts, and other provisions that would affect on-budget totals.

¹Assumptions underlying the no action path are shown on the following slide.

Appendix I: No Action Model Assumptions

Model Inputs	Assumptions
Unified surplus/deficit	CBO through 2008; GAO simulations thereafter
Social Security spending (OASDI)	1999 Social Security Trustees' Intermediate projections
Medicare spending (HI and SMI)	1999 Medicare Trustees' Intermediate projections
Medicaid spending	CBO's projections
Other mandatory spending	CBO's assumed levels through 2008; thereafter increases at the rate of economic growth (i.e. remains constant as a share of GDP)
Discretionary spending	CBO through 2008; thereafter increases at the rate of economic growth
Receipts	CBO's assumed levels through 2008; in subsequent years, receipts held constant at 21.1% of GDP (CBO's projection in 2008)
Saving rate: gross saving of the private sector and state and local government sector	17.4%
Share of gross national saving that flows abroad	33.3%
Labor: growth in hours worked	1999 Social Security Trustees' Intermediate projections
Total factor productivity growth	1.1%
Inflation (GDP price index)	CBO through 2009; 1.9% thereafter (CBO's projection in 2009)
Interest rate (average on the national debt)	Average rate implied by CBO's interest payment projections through 2008; 5.6% thereafter (CBO's implied rate in 2008)

Note 1. These assumptions apply to our base simulation, no action. For alternative fiscal policy simulations, certain assumptions are varied, which are noted in the discussion of the alternative paths.

Note 2. In our work, all CBO budget projections were converted from a fiscal year to a calendar year basis. The last year of CBO's projection period is fiscal year 2009, permitting the calculations of calendar year values through 2008.

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